



To the Board of Supervisors
County of San Bernardino, California

December 10, 2003

Ladies and Gentlemen:

We have audited the basic financial statements of the County of San Bernardino (the County) for the year ended June 30, 2003 and have issued our report thereon dated November 26, 2003. In planning and performing our audit of the basic financial statements of the County, we considered internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements. An audit does not include examining the effectiveness of internal control and does not provide assurance on internal control. We have not considered internal control since the date of our report.

During our audit we noted certain matters involving internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management, are intended to improve internal control or result in other operating efficiencies and are summarized as follows:

CUTOFF

OBSERVATION

County departments are required to prepare and submit year-end accrual packages by July 15th to the County Administrative Office (CAO). The accrual packages include worksheets listing the amount, expenditure and/or object code, description of service, contract claim, invoice or reference number and the date that the item was received or service was rendered. The completion of this year-end closing procedure dictates the timing of the Auditor/Controller/Recorder's (ACR) preparation and completion of the Comprehensive Annual Financial Report (CAFR).

During our examination, it was noted that the ACR's office accelerated the timing and cutoff of accrual packages in order to complete the CAFR in a timely manner. However, it was noted that numerous accruals, primarily pertaining to accounts payable, were not recorded as a result of the accelerated timeline. There were significant liabilities for goods and services, including capital assets, received prior to year-end which had not been accrued in the respective year-end fund general ledgers, resulting in audit adjustments totaling \$6,400,000.

RECOMMENDATION

Although it is noted that formal written communication and training is performed on an annual basis by the ACR's office to properly provide year-end closing procedures to County departments, we recommend that the ACR implement additional procedures to ensure that material transactions are accrued in the proper period. These procedures should include the following:

- Departments should be instructed to estimate recurring monthly expenditures based on the best available information in order to ensure timely processing by the ACR's office.
- The ACR's office should utilize either internal auditors or general accounting personnel to perform testing procedures subsequent to the accounting year-end date to validate County departments' year-end estimates.
- Based on the outcome of these results, document and record necessary adjustments to the financial statements.

By implementing additional procedures, material transactions requiring accrual may be identified and corrected in a timely manner in order to facilitate the audit process and issuance of the County's CAFR.

RESPONSE

The Auditor/Controller-Recorder's (ACR) Office agrees with the recommendation and will implement procedures to analyze transactions subsequent to the cutoff date to ensure that material transactions are accrued in the proper period. In addition, ACR will instruct departments to submit estimated accruals for unbilled goods or services received at or prior to year-end cutoff.

RECONCILIATION OF SPECIAL DISTRICTS FIXED ASSETS

OBSERVATION

The County's General Accounting Department implemented a centralized fixed assets subsidiary ledger in the prior year to comply with GASB 34 reporting requirements. We noted this subsidiary ledger is reconciled to the General Ledger and is used to prepare the County's Consolidated Annual Financial Report. We noted that the County's Internal Audit Division is responsible for providing to General Accounting adjustments to the fixed assets subsidiary ledger for the Special District Funds, through the annual audit of these Special Districts. During our examination of fixed assets it was noted that the schedules generated through the fixed assets subsidiary ledger, listing additions and deletions, could not be reconciled to the Special District reports. We noted multiple immaterial discrepancies.

RECOMMENDATION

The County's General Accounting department should implement procedures to ensure no post-closing adjustments to the fixed assets subsidiary ledger are performed after the annual accrual cut-off period. Any additional adjustments made to the subsidiary ledger for Special District Funds should be limited to audit adjustments proposed by the Internal Audit Division and the County's outside auditors.

RESPONSE

The General Accounting Section and the Internal Audit Section of the Auditor/Controller-Recorder's Office will implement procedures to reconcile the Special District's capital assets schedules to the County's capital asset ledger.

FREQUENCY OF ACTUARIAL REPORTS

OBSERVATION

Over the past fiscal years, the County has made over \$50 million dollars in adjustments to their self-insurance reserves. These adjustments have resulted from the ever-increasing costs and claims related to workers' compensation. Currently, the County has an actuarial study performed by an outside consultant every two years. The actuary provides the County with estimated loss reserve balances for the first and second year based on prior year claim data. As such, historical claim data is currently not considered for the period when no actuarial study is performed. During the "off-year" that an actuarial study has not been obtained, the County's Risk Management Division performs an internal analysis which historically has decreased the County's Risk Management related liabilities.

RECOMMENDATION

Because of the volatility of the costs related to workers' compensation, we recommend that the County have an actuarial study performed on annual basis. By having this study performed annually, the most current claim data will be utilized by the actuary to project the needed reserves resulting in a more accurate accrual each year. In addition, this more frequent analysis will lend to the County being able to better assess their costs and charge the appropriate fees to each department on a timely basis.

At a minimum, the County should not adjust its risk management liabilities pertaining to "incurred but not reported" losses during the years where actuarial studies are not performed. This would result in a more conservative approach to recording these liabilities and prevent significant fluctuations in these liabilities between accounting periods.

RESPONSE

Risk Management does not recommend annual studies because of the significant costs that are not justifiable under the current financial conditions.

Risk Management performs annual cash flow analysis. In 2000 the Board of Supervisors approved a Five-Year Recovery Plan for the Risk Management Program. In the third year of this plan, the Board approved Risk Management rate increases for fiscal year 2003-04 that will generate over \$12 million of additional cash compared to fiscal year 2002-03. The Board also approved the Experience Modification for Workers' Compensation that will increase the rates for departments with adverse loss experience. Additionally, the Board approved the County Workers' Compensation rates be set at 75% of the state's prime rates. This will allow Risk Management to annually adjust the rates to more accurately reflect the loss trends in the state. A practice that has and will continue until we are able to fund the programs based on actuarial recommended levels.

Management agrees that adjustments should not be made to reduce the Risk Management liabilities pertaining to "incurred but not reported" losses during the years where actuarial studies are not performed.

SEGREGATION OF DUTIES - PAYRATE OVERRIDE

OBSERVATION

During our test-work over the payroll process, we noted employees in Central Payroll have the ability to view and edit County employee pay rates. We understand, and agree the ability to view and adjust pay rates is necessary to accommodate certain types of employee leave integration. An exception report is generated each pay period that lists all instances of pay rate overrides, including the employee making the change. This report is subject to review by one EMACS system administrator – no secondary or upper management review is conducted. In addition, the system administrator reviewing the report also has the ability to override pay rates, including their own rate.

RECOMMENDATION

We recommend that upper management periodically review the pay rate override exception report to ensure no improprieties exist. Additionally, the County should implement restricted access within its payroll system to ensure only a select few employees in Central Payroll have the ability to adjust employee pay rates. The above recommendation will improve the control of pay rate adjustments and assure employees are paid according to the approved rate.

RESPONSE

We understand the observation and agree with the recommendations noted. Changes to operations will be implemented to incorporate these control measures.

FEDERAL AWARD REPORTING

OBSERVATION

During our examination of the County's procedures of compiling the Schedule of Expenditures of Federal Awards (SEFA) under the Office of Management and Budget (OMB) Circular A-133, it was noted that revenues are not consistently recorded between federal and state sources. In several circumstances, it was noted that federal revenue amounts were recorded within state revenue source object codes and visa versa. Although this practice does not misstate the County's revenues at the financial statement level, it does allow for the potential misstatement of expenditures under federal reporting requirements.

RECOMMENDATION

We recommend that the County modify its procedures to classify current year revenues to be based on the proper allocation to either federal or state revenue source object codes. By implementing such a procedure, this would streamline the reporting process required under OMB Circular A-133 and provide additional control over the presentation of the SEFA.

RESPONSE

The Auditor/Controller-Recorder's Office will work with other County departments to re-evaluate the current procedures for future modifications.

GANN LIMIT

OBSERVATION

During our testing of the County's annual appropriation limit pursuant to Article XIII-B of the California Constitution, it was noted that the annual inflation and population factors were not explicitly identified in the Board of Supervisor resolution adopting the current year limit.

RECOMMENDATION

We recommend that the inclusion of the population and inflation factors be explicitly identified in the Board of Supervisor resolution to ensure compliance with the GANN limit requirements of the California Constitution.

RESPONSE

The Auditor/Controller-Recorder's Office agrees with the recommendation and will implement procedures to ensure compliance with the GANN limit requirements of the California Constitution.

NEW GASB POUNDNOUNCEMENTS

OBSERVATION

In May 2002, the Governmental Accounting Standards Board voted to issue Statement No. 39, *Determining Whether Certain Organizations Are Component Units—an amendment of GASB Statement No. 14*. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2003. Earlier application is encouraged.

An objective of Statement No. 14, *The Financial Reporting Entity*, is that all entities associated with a primary government are potential component units and should be evaluated for inclusion in the financial reporting entity. This Statement amends Statement No. 14 to provide additional guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. Generally, it requires reporting, as a component unit, an organization that raises and holds economic resources for the direct benefit of a governmental unit.

Organizations that are legally separate, tax-exempt entities and that meet *all* of the following criteria should be discretely presented as component units. These criteria are:

1. The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.
2. The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.
3. The economic resources received or held by an *individual organization* that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.

This Statement continues the requirement in Statement No. 14 to apply professional judgment in determining whether the relationship between a primary government and other organizations for which the primary government is not financially accountable and that do not meet these criteria is such that exclusion of the organization would render the financial statements of the reporting entity misleading or incomplete. Those component units should be reported based on the existing blending and discrete presentation display requirements of Statement No. 14.

RECOMMENDATION

We recommend that the County perform a review of the agencies, committees and boards whose members are appointed by the County's Board of Supervisors. This review should be performed to identify the existence and nature of any component units or agencies requiring inclusion in the County's financial reporting entity under GASB 39.

NEW AUDITING STANDARDS ON FRAUD

OBSERVATION AND RECOMMENDATION

In October of 2002, the Auditing Standards Board voted to issue Statement of Auditing Standards (SAS) No. 99, "Consideration of Fraud in the Financial Statement Audit." These standards will be effective for the County for the fiscal year ending June 30, 2004. The provisions of this standard will continue to require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. This standard provides guidance to auditors in how to better fulfill this responsibility.

In fiscal year 2004, auditors will be required to complete the following:

- Making inquiries of management and others within the entity such as operating personnel, internal audit and in-house legal counsel regarding the risk of fraud and programs/controls in place to prevent and detect fraud.
- Conducting internal planning discussions with the engagement team regarding the risk of fraud and the overall control environment.

We expect these additional procedures to increase audit time slightly and require additional time of County personnel.

Our audit procedures are designed primarily to enable us to form an opinion on the financial statements, and therefore may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of the County gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

This report is intended solely for the information and use of the Board of Supervisors, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

Vavinek, Trine, Day & Co, LLP

Rancho Cucamonga, California
December 10, 2003